

# South Carolina Law Review

---

Volume 59  
Issue 3 *ANNUAL SURVEY OF SOUTH CAROLINA  
LAW*

---

Article 3

Spring 2008

## **McCullough v. Goodrich & (and) Pennington Mortgage Fund, Inc.: Are Secured Creditors Really Secure from Third Party Impairment of Collateral**

R, Davis Rice

Follow this and additional works at: <https://scholarcommons.sc.edu/sclr>



Part of the [Law Commons](#)

---

### **Recommended Citation**

Rice, R, Davis (2008) "McCullough v. Goodrich & (and) Pennington Mortgage Fund, Inc.: Are Secured Creditors Really Secure from Third Party Impairment of Collateral," *South Carolina Law Review*. Vol. 59 : Iss. 3 , Article 3.

Available at: <https://scholarcommons.sc.edu/sclr/vol59/iss3/3>

This Article is brought to you by the Law Reviews and Journals at Scholar Commons. It has been accepted for inclusion in South Carolina Law Review by an authorized editor of Scholar Commons. For more information, please contact [dillarda@mailbox.sc.edu](mailto:dillarda@mailbox.sc.edu).

***MCCULLOUGH V. GOODRICH & PENNINGTON MORTGAGE FUND, INC.:  
ARE SECURED CREDITORS REALLY “SECURE” FROM THIRD PARTY  
IMPAIRMENT OF COLLATERAL?***

I. INTRODUCTION

In any secured transaction, the lender and the debtor typically agree on the type of collateral that will be subject to the lender's security interest.<sup>1</sup> Both parties have made a conscious decision to determine what particular property belonging to the debtor will be used to secure the loan.<sup>2</sup> When the two parties contemplate securing a loan with collateral, “the real subject matter of the secured transaction is the economic value of the collateral.”<sup>3</sup> Additionally, inherent in any security agreement is the emergence of a “bundle of rights” associated with the collateral that is intimately tied to the economic value of the collateral.<sup>4</sup> As a general proposition, commercial law should respect secured parties' bundle of rights by attempting to ensure that the collateral maintains its economic value and by “protect[ing] secured parties against actions and events that effectively reduce the collateral's economic value.”<sup>5</sup> But how far should courts go in affording protection to a secured party when the value of the collateral has been impaired? More specifically, should courts allow a secured party to maintain a cause of action for negligence against a third party for causing a reduction in the value of the collateral?

Recently, the South Carolina Supreme Court addressed this precise question by accepting the following certified question from the United States District Court for the District of South Carolina: “Does South Carolina law recognize a secured creditor's right to bring a claim for negligent/wrongful impairment of collateral where a third party's negligence or other actions caused the erosion, destruction, or reduction in value of the secured party's collateral?”<sup>6</sup> For the court, the answer depended on whether there is any basis in South Carolina law recognizing an independent legal duty owed by a third party to a secured creditor such that a secured creditor may maintain an independent tort claim against the third party.<sup>7</sup> Concluding that there is no contractual relationship,<sup>8</sup> property interest in intangible collateral,<sup>9</sup> special circumstance,<sup>10</sup> or statutory scheme<sup>11</sup> that provides a basis for

---

1. See Lars S. Smith, *General Intangible or Commercial Tort: Moral Rights and State-Based Intellectual Property as Collateral Under U.C.C. Revised Article 9*, 22 EMORY BANKR. DEV. J. 95, 99 (2005).

2. See *id.*

3. R. Wilson Freyermuth, *Rethinking Proceeds: The History, Misinterpretation and Revision of U.C.C. Section 9-306*, 69 TUL. L. REV. 645, 694 (1995).

4. See Harold R. Weinberg, *Secured Party's Right to Sue Third Persons for Damage to or Defects in Collateral*, 81 COM. L.J. 445, 448 (1976).

5. Freyermuth, *supra* note 3, at 694.

6. McCullough v. Goodrich & Pennington Mortg. Fund, Inc., 373 S.C. 43, 47, 644 S.E.2d 43, 45–46 (2007).

7. See *id.* at 47, 644 S.E.2d at 46.

8. *Id.* at 50, 644 S.E.2d at 47.

9. *Id.* at 52, 644 S.E.2d at 48.

10. *Id.* at 53, 644 S.E.2d at 49.

11. *Id.* at 55, 644 S.E.2d at 50.

recognizing a legal duty between a secured creditor and a third party, the court held “that South Carolina law does not recognize a secured creditor’s independent claim against a third party for negligent impairment of collateral.”<sup>12</sup>

As this Note argues, the court should have held that a security interest in any form of collateral is a sufficient property interest to form the basis for recognizing a secured party’s right to bring an independent tort claim against a third party for impairing the value of the collateral. The security interest at issue in *McCullough* was the right to receive payments under a contract between the debtor and a third party.<sup>13</sup> The court distinguished between tangible personal property and intangible collateral, concluding that while a property interest in tangible personal property could provide a basis for a secured creditor’s claim against a third party, a secured creditor’s interest in intangible collateral, such as the “contractual right to receive payments,”<sup>14</sup> does not provide the same basis for such a claim.<sup>15</sup> As this Note discusses, the court’s distinction is unwarranted. Because there is a bundle of rights associated with any security interest in collateral,<sup>16</sup> the law should fully protect a security interest in collateral. Thus, a security interest in any form of collateral should provide a basis for recognizing a secured party’s right to maintain a tort claim against a third party for impairing the collateral’s value.

Although at first glance *McCullough* may appear to leave a secured creditor without relief against third party impairment of collateral, this is not necessarily the case. This Note articulates two options courts may choose from to protect a secured party against third party impairment of collateral. Under South Carolina’s revised version of article 9 of the Uniform Commercial Code (Article 9), upon default by the debtor, the secured creditor, by exercising the debtor’s rights against the third party, may maintain an action against a third party that impairs the value of the collateral.<sup>17</sup> Additionally, a secured party may be able to protect itself before the debtor defaults by obtaining an assignment of the debtor’s accrued cause of action against the third party.<sup>18</sup> However, under either option, a secured creditor may only assert the debtor’s rights in bringing a claim against a third party as, after *McCullough*, the secured party has no independent rights against the third party.<sup>19</sup> Nonetheless, secured creditors will often be able to protect themselves, at least to some extent, from third parties impairing the value of collateral.

Part II of this Note begins with a brief explanation of the various reasons parties choose to enter into secured transactions, reviewing the benefits to both the secured lender and the debtor of securing loans with collateral. Part II next provides the facts and procedural history that led the district court to certify the question at issue to the South Carolina Supreme Court. Finally, Part II concludes with a brief description of the court’s holding and articulated reasoning. Part III of this Note argues that a security interest in any form of collateral is a sufficient property interest to warrant recognition of a secured party’s right to maintain a tort claim

---

12. *Id.*

13. *Id.* at 46, 644 S.E.2d at 45.

14. *Id.*

15. *Id.* at 52, 644 S.E.2d at 48.

16. See Weinberg, *supra* note 4.

17. S.C. CODE ANN. § 36-9-607(a)(3) cmt. 3 (2003).

18. See *infra* text accompanying notes 164–66.

19. *McCullough*, 373 S.C. at 55, 644 S.E.2d at 50.

against a third party for impairing the collateral. Part III then presents alternatives that may offer protection to secured parties when a third party impairs their collateral, notwithstanding the *McCullough* court's refusal to permit a secured creditor to bring its own independent claim against the third party. Finally, Part IV concludes by suggesting that the *McCullough* court's recognition of such a claim would have created greater certainty for secured creditors by ensuring adequate protection of their rights in the collateral. However, because secured creditors are now less certain that courts will protect their interests from events that impair the value of their collateral, they may be forced to raise their interest rates, ultimately adversely impacting consumers.

## II. BACKGROUND

### A. *Why Parties Enter into Secured Transactions*

The practice of securing loans with some form of collateral is a prominent feature in the domestic economy.<sup>20</sup> But why exactly do parties use secured forms of credit? A full understanding of the reasons why parties enter into secured transactions reveals why the economic value of the security interest is of primary importance in any secured transaction.

Generally, the primary purpose of securing loans with collateral is "to assure repayment of the debt in case of default."<sup>21</sup> Thus, the most obvious advantage to the lender for issuing secured credit is the lender's direct legal right to take and liquidate the collateral used to secure the loan in order to collect on the borrower's outstanding debt.<sup>22</sup> Thus, a secured creditor's legal right to take the collateral enhances the ability to ensure repayment. Three important features of the law of secured credit<sup>23</sup> increase the lender's leverage in such situations.<sup>24</sup> First, securing credit with collateral gives priority to the lender so that the lender is paid before other creditors.<sup>25</sup> Second, securing credit with collateral results in an encumbrance on the collateral, giving the lender a permanent interest in a particular asset.<sup>26</sup> Finally, such an arrangement enhances the lender's ability to force repayment more quickly than when the debt is unsecured.<sup>27</sup> Because of this enhanced ability to enforce repayment of the secured loan, the lender is more confident that he will recover the debt owed than when the transaction is unsecured. Thus, a secured creditor is relieved of most of the financial risk if the debtor defaults on the loan. Because "the real subject matter of [a] secured transaction is the economic value

---

20. Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 627 (1997) (stating that during the mid-1990s domestic lenders held approximately \$2 trillion in secured debt).

21. *MBank Grand Prairie v. State*, 737 S.W.2d 424, 427 (Tex. Ct. App. 1987).

22. See Mann, *supra* note 20, at 639 (citing Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 7 (1981)). However, as Professor Mann appropriately points out, lenders must face the risk that liquidation of the collateral may not always result in full repayment of the principal and interest. *Id.* at 640 n.55.

23. See Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1921 (1994) ("Security offers the user some combination of three features, . . . priority, encumbrance, and remedy.").

24. Mann, *supra* note 20, at 639 (citing LoPucki, *supra* note 23, at 1921–23).

25. *Id.*

26. *Id.*

27. *Id.*

of the collateral,”<sup>28</sup> a secured creditor’s relief from the risk of the borrower’s default only exists to the extent that the collateral maintains its value.

Additionally, there are less direct and more subtle advantages for the lender with a loan secured by collateral.<sup>29</sup> These advantages “have significance” before the lender ever attempts to enforce repayment by exercising its legal right to take the collateral.<sup>30</sup> Specifically, because of the lender’s pending legal right to take the collateral in the event of default, the borrower has an increased incentive to voluntarily repay the loan.<sup>31</sup> Thus, this indirect advantage to the lender stems from the lender’s aforementioned direct advantage of the ability to collect the collateral to force repayment.<sup>32</sup> Increasing the incentive of a borrower to voluntarily repay the loan is a considerable advantage to the secured lender, as “[t]he borrower’s voluntary decision to repay the loan protects the lender from the vagaries of the liquidation process[] and saves the lender the time and hassle . . . of pursuing the borrower and the collateral.”<sup>33</sup>

Furthermore, extending secured credit can reduce the lender’s cost of monitoring the borrower for risky behavior that could significantly increase the possibility that the lender will not receive full repayment of the loan.<sup>34</sup> By securing a loan with collateral, the lender is able to “focus his attention on the continued availability of [the] collateral” and the maintenance of its value;<sup>35</sup> therefore, the lender is “free to disregard” activities of the debtor unassociated with the collateral.<sup>36</sup> As a result, the monitoring required to prevent the debtor from engaging in conduct that would increase the likelihood of nonpayment is likely to be considerably less for a secured lender than an unsecured lender,<sup>37</sup> who typically must monitor the debtor’s activities with regard to the debtor’s entire estate. By focusing his attention on the collateral itself, “the secured creditor can reduce the number and complexity of his monitoring tasks and thus achieve a substantial savings in monitoring costs.”<sup>38</sup>

Moreover, the advantages of secured credit transactions are not solely limited to the lender. Because securing a loan with collateral lowers the risk of nonpayment, the lender is able to offer a loan at a lower interest rate or on more consumer-friendly terms than the lender would otherwise be able to offer in an unsecured transaction.<sup>39</sup> Additionally, conventional wisdom suggests that due to the availability of secured credit, lenders extend credit to high risk debtors in situations

28. Freyermuth, *supra* note 3.

29. See Mann, *supra* note 20, at 638–39.

30. *Id.* at 640.

31. *Id.* at 645 n.72 (explaining that borrowers “react[] to the ‘shadow’ of the law” by anticipating what would happen if the lender exercised its legal right).

32. *Id.*

33. *Id.* at 647.

34. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1152–53 (1979) (“[T]he existence of collateral is also likely to reduce the cost of the monitoring required to guard against the debtor covertly increasing the riskiness of the loan.”).

35. *Id.* at 1153.

36. *Id.*

37. *Id.*

38. *Id.*

39. Mann, *supra* note 20, at 667.

where they would hesitate to extend unsecured credit.<sup>40</sup> Thus, debtors will often offer a lender some form of collateral in order to secure a loan.

Because the value of the collateral assures loan repayment to the lender upon default and allows the debtor to receive a lower interest rate, parties to security agreements are likely to concern themselves with the economic value of the collateral. Therefore, providing certainty that the collateral will maintain its value serves to protect the parties' bargained-for security arrangement. But how far should courts go to ensure that the collateral maintains its economic value? Should a secured party have the right to bring an independent tort claim against a third party that has impaired the value of the collateral? In *McCullough*, the South Carolina Supreme Court confronted this precise issue.

## *B. McCullough v. Goodrich & Pennington Mortgage Fund, Inc.*

### *1. Facts and Procedural History*

In 1997, Goodrich & Pennington Mortgage Fund, Inc. (G&P), a mortgage lender, entered into a contractual agreement with Advanta Mortgage Corporation (Advanta) whereby Advanta agreed to "service" certain mortgages originated by G&P.<sup>41</sup> Essentially, Advanta was required to collect money due on the G&P mortgages and to take "appropriate action when a borrower" defaulted on an obligation to pay.<sup>42</sup> Under the terms of its agreement, Advanta was to make payments to G&P relating to the servicing of the mortgage loans.<sup>43</sup>

In 1999, HomeGold Financial, Inc. (HomeGold) loaned approximately \$1 million to G&P.<sup>44</sup> As collateral for these loans, HomeGold took a security interest in the contractual rights of G&P to receive payment from Advanta.<sup>45</sup> G&P notified Advanta of the security agreement that it had with HomeGold.<sup>46</sup> In 2001, Advanta named Chase Home Finance, LLC (Chase) its attorney-in-fact for servicing the mortgages originated by G&P.<sup>47</sup>

Ultimately, G&P defaulted on its loan from HomeGold in 2005.<sup>48</sup> Meanwhile, HomeGold had filed for protection under chapter 11 of the Bankruptcy Code.<sup>49</sup> Ralph McCullough was appointed as plan trustee for HomeGold's bankruptcy estate,<sup>50</sup> and he brought an action in the United States District Court for the District of South Carolina against G&P for breach of contract.<sup>51</sup> Additionally, the plan trustee brought an action against Advanta and Chase for negligent and wrongful

---

40. See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 901–02 (1986).

41. *McCullough v. Goodrich & Pennington Mortg. Fund, Inc.*, 373 S.C. 43, 46, 644 S.E.2d 43, 45 (2007).

42. *Id.* at 46 n.1, 644 S.E.2d at 45 n.1.

43. *Id.* at 46, 644 S.E.2d at 45.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. See *id.*

50. See *id.* at 43, 46 n.2, 644 S.E.2d at 43, 45 n.2.

51. *Id.* at 46, 644 S.E.2d at 45.

impairment of collateral.<sup>52</sup> In particular, the complaint alleged that Advanta and Chase had been negligent in the servicing of G&P's mortgage loans, thereby impairing HomeGold's security interest in G&P's contractual rights to receive payment under the agreement with Advanta.<sup>53</sup>

In granting Advanta's and Chase's motions to dismiss, the district court held that South Carolina did not recognize a claim for negligent impairment of collateral, and, therefore, the complaint failed to state a claim upon which relief could be granted.<sup>54</sup> HomeGold's trustee then moved for the district court to reconsider its ruling and to certify the issue for review by the South Carolina Supreme Court.<sup>55</sup> The district court granted the trustee's motion and certified the following question to the South Carolina Supreme Court: "Does South Carolina law recognize a secured creditor's right to bring a claim for negligent/wrongful impairment of collateral where a third party's negligence or other actions caused the erosion, destruction, or reduction in value of the secured party's collateral?"<sup>56</sup>

## 2. *Holding and Court's Reasoning*

In answering the certified question, the South Carolina Supreme Court held that "South Carolina law does not recognize a secured creditor's *independent* claim against a third party for negligent impairment of collateral."<sup>57</sup> The court articulated that in order for a secured creditor to maintain such an independent tort claim, South Carolina must recognize a legal duty between the third party and the secured creditor.<sup>58</sup> The court noted that such a legal duty may arise "by statute, a contractual relationship, status, property interest, or some other special circumstance."<sup>59</sup>

### a. *No Duty Arising by Contractual Relationship*

First, the South Carolina Supreme Court held that the contractual relationship between Advanta and G&P did not give rise to a legal duty owed by Advanta to HomeGold, G&P's secured creditor.<sup>60</sup> In arguing for the existence of a legal duty, the trustee cited several prior South Carolina cases where the supreme court found that a contractual relationship between a tortfeasor and one party provided a basis

52. *Id.* at 46–47, 644 S.E.2d at 45.

53. *Id.* at 47, 644 S.E.2d at 45. The complaint also alleged that G&P had itself brought a claim against Advanta by way of an arbitration proceeding, as the agreement between G&P and Advanta required arbitration of all claims arising from the contract to be arbitrated. *See* Complaint at 11, *McCullough v. Goodrich & Pennington Mortg. Fund, Inc.*, No. 8:05-cv-3354-GRA (D.S.C. Dec. 2, 2005), 2005 U.S. Dist. Ct. Pleadings LEXIS 8645, at \*15–16. However, the complaint further alleged that G&P had withdrawn its claims in the arbitration without prejudice. *Id.*

54. *McCullough*, 373 S.C. at 47, 644 S.E.2d at 45.

55. *Id.*

56. *Id.* at 47, 644 S.E.2d at 45–46.

57. *Id.* at 55, 644 S.E.2d at 50 (emphasis added).

58. *Id.* at 48, 644 S.E.2d at 46.

59. *Id.* at 47–48, 644 S.E.2d at 46 (citing *Madison v. Babcock Ctr., Inc.*, 371 S.C. 123, 136, 638 S.E.2d 650, 656–57 (2006)).

60. *Id.* at 50, 644 S.E.2d at 47.

for a legal duty owed by the tortfeasor to an injured third party.<sup>61</sup> However, the court distinguished between the situation in which a secured creditor obtains a security interest in contractual rights and the situations in which the court has established a contractual basis for a duty owed to a third party.<sup>62</sup> The court noted that there is a contractual basis for a legal duty owed by a tortfeasor to a third party only in situations where the third party is an intended beneficiary of the contract or where the third party is a “foreseeable ‘user’” of the tortfeasor’s product.<sup>63</sup> Because HomeGold was not an intended beneficiary of the contract between G&P and Advanta, and because the contract was not executed to provide HomeGold with collateral, the court found that the contract failed to provide a basis for establishing an independent duty.<sup>64</sup> Furthermore, the court found that HomeGold was not a foreseeable user of G&P’s contractual rights with Advanta.<sup>65</sup> Therefore, the court concluded that there is no contractual basis for recognizing a secured creditor’s claim against a third party for negligent impairment of collateral.<sup>66</sup>

*b. No Duty Arising from a Property Interest*

The court also found that there was no property interest in HomeGold’s security interest in G&P’s contractual rights to payment that could give rise to a legal duty owed by Advanta to HomeGold.<sup>67</sup> The court *did* recognize that existing South Carolina law does allow a mortgagee with a security interest in tangible personal property “to recover damages from a third party for conversion, injury or destruction of the collateral.”<sup>68</sup> However, the court refused to analogize a creditor’s security interest in tangible personal property to HomeGold’s security interest in intangible rights to payment.<sup>69</sup> The court did not “believe that a security interest in intangible collateral creates the same basis for a legal duty as a secured party’s interest in tangible personal property.”<sup>70</sup> Thus, the court held there was “no property interest in intangible collateral giving rise to a claim by a secured creditor against a third party for negligent impairment” of that collateral.<sup>71</sup>

---

61. *Id.* at 48, 644 S.E.2d at 46. Specifically, the trustee directed the court’s attention to the following cases: *Dorrell v. South Carolina Department of Transportation*, 361 S.C. 312, 605 S.E.2d 12 (2004), which held that a subcontractor hired to pave a road owed a legal duty to the motorists using the road, *id.* at 320, 605 S.E.2d at 16; *Barker v. Sauls*, 289 S.C. 121, 345 S.E.2d 244 (1986), where the court found that an insurance agent who entered into a contract to sell workers’ compensation coverage to an employer owed a legal duty to an employee, *id.* at 122, 345 S.E.2d at 244–45; *Terlinde v. Neely*, 275 S.C. 395, 271 S.E.2d 768 (1980), which held that a homebuilder who contracted with a homeowner owed a legal duty to the subsequent purchasers of the home, *id.* at 399, 271 S.E.2d at 770; and *Edward’s of Byrnes Downs v. Charleston Sheet Metal Co.*, 253 S.C. 537, 172 S.E.2d 120 (1970), where the court found that a roofer who contracted with a building owner owed a legal duty to the occupants of adjacent buildings, *id.* at 542–43, 172 S.E.2d at 122–23.

62. *McCullough*, 373 S.C. at 49, 644 S.E.2d at 47.

63. *Id.* at 49–50, 644 S.E.2d at 47.

64. *Id.*

65. *Id.* at 50, 644 S.E.2d at 47.

66. *Id.*

67. *Id.* at 52, 644 S.E.2d at 48.

68. *Id.* at 50, 644 S.E.2d at 47 (citing *Wilkes v. S. Ry. Co.*, 85 S.C. 346, 347–48, 67 S.E. 292, 293 (1910)).

69. *Id.* at 52, 644 S.E.2d at 48.

70. *Id.*

71. *Id.*



*c. No Duty Arising from Special Circumstances*

The court then considered whether there were special circumstances involving secured creditors and their collateral that should give rise to a legal duty owed to a third party.<sup>72</sup> The court noted that its jurisprudence had recognized a legal duty owed by a professional to a third party based on the “special relationship” between the parties.<sup>73</sup> However, the court found “no basis for such a professional duty running from a third party to a secured creditor.”<sup>74</sup>

Additionally, the court stated that it had previously recognized a duty between a tortfeasor and a third party under special circumstances where there were significant policy reasons that justified finding such a duty.<sup>75</sup> However, the court felt that the bargaining positions of secured creditors and the current nature of secured transactions did not implicate any legitimate policy concerns—such as unequal bargaining positions between the parties—that would justify finding a legal duty between a secured creditor and a third party.<sup>76</sup> Accordingly, the court found no special circumstances regarding secured credit transactions that would provide a basis for a tort claim by a secured creditor against a third party for negligent impairment of collateral.<sup>77</sup>

*d. No Duty Arising by Statute*

Finally, the court held that Article 9, as adopted by South Carolina,<sup>78</sup> does not establish a statutory duty between a secured creditor and a third party that would create an independent cause of action for negligent impairment of collateral.<sup>79</sup> The court rejected the trustee’s argument that section 36-9-607(a)(3) of the South

72. *See id.* at 52–53, 644 S.E.2d at 48–49.

73. *See id.* (citing *Tommy L. Griffin Plumbing & Heating Co. v. Jordan, Jones & Goulding, Inc.*, 320 S.C. 49, 53, 463 S.E.2d 85, 87 (1995); *Kennedy v. Columbia Lumber & Mfg. Co.*, 299 S.C. 335, 347, 384 S.E.2d 730, 738 (1989)). In *Griffin*, the court held that a professional design engineer who contracted with the County of Charleston to design a water tank and supervise the project for the county owed a duty to a different firm, which had contracted with the county to construct the water tank, to design and to supervise the project with due care. *Griffin*, 320 S.C. at 56, 463 S.E.2d at 89. South Carolina courts have also held that other professionals may owe a legal duty to third parties based on the special relationship between the professional and the third party. *See, e.g., S.C. Ports Auth. v. Booz-Allen & Hamilton, Inc.*, 289 S.C. 373, 376–77, 346 S.E.2d 324, 326 (1986) (holding that a consulting firm contracting with the plaintiff’s commercial competitor owed a duty to accurately report objective factual data about the plaintiff); *Lloyd v. Walters*, 276 S.C. 223, 226, 277 S.E.2d 888, 889 (1981) (holding an attorney liable to a corporate shareholder when the attorney breached his duty to the corporation).

74. *McCullough*, 373 S.C. at 52, 644 S.E.2d at 48.

75. *See id.* at 53, 644 S.E.2d at 49 (citing *Kennedy v. Columbia Lumber Mfg. Co.*, 299 S.C. 335, 347, 384 S.E.2d 730, 738 (1989)). In *Kennedy*, the court found that a homebuilder owed a legal duty to prevent economic harm to future homebuyers. *Kennedy*, 299 S.C. at 347, 384 S.E.2d at 738. The *Kennedy* court noted that since the post-World War II housing boom, modern homebuyers no longer supervised construction and no longer enjoyed equal bargaining positions, a situation that called for increased protection of the innocent future homebuyer. *Id.* at 343–44, 384 S.E.2d at 735–36 (citations omitted).

76. *McCullough*, 373 S.C. at 53, 644 S.E.2d at 49.

77. *Id.*

78. S.C. CODE ANN. §§ 36-9-101 to -709 (2003 & Supp. 2006).

79. *McCullough*, 373 S.C. at 55, 644 S.E.2d at 50.

Carolina Code<sup>80</sup> provides a secured creditor with the right to such a cause of action.<sup>81</sup> In fact, the court held that section 36-9-607(e)<sup>82</sup> specifically refutes the trustee's theory that a statutory duty exists between a secured creditor and a third party.<sup>83</sup> Additionally, the court noted that Article 9, as adopted by South Carolina, provides ample means for a secured creditor to protect its security interest from a reduction in value due to a third party's actions, without establishing a legal duty between a secured creditor and a third party.<sup>84</sup> Therefore, the court found no statutory basis for recognizing a cause of action between such parties for impairment of collateral.<sup>85</sup> Finding no duty arising by contract, personal property interest, special circumstance, or statute, the South Carolina Supreme Court accordingly held that "South Carolina law does not recognize a secured creditor's independent claim against a third party for negligent impairment of collateral."<sup>86</sup>

### III. CRITIQUE OF *MCCULLOUGH*

The South Carolina Court of Appeals has stated that "a duty is not sacrosanct in itself but only an expression of the sum total of those considerations of policy which lead the law to say that a particular plaintiff is entitled to protection."<sup>87</sup> A secured party that has a security interest impaired by a third party should be a plaintiff "entitled to protection."<sup>88</sup> After all, a secured party's security interest is a bargained-for form of protection.<sup>89</sup> If a wrongdoer interferes with that protection, the law should provide a remedy in the form of a right of action against that wrongdoer. However, under South Carolina law, a legal duty to prevent harm to another must arise as a result of a contractual relationship, property interest, special circumstance, or statutory scheme.<sup>90</sup> The South Carolina Supreme Court could have recognized a secured creditor's right to bring an action against a third party for impairing collateral based on the property interest a secured creditor holds.

---

80. Section 36-9-607(a)(3) provides as follows:

[A]fter [a debtor's] default, a secured party . . . may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral.

S.C. CODE ANN. § 36-9-607(a)(3) (2003).

81. *McCullough*, 373 S.C. at 53–54, 644 S.E.2d at 49.

82. Section 36-9-607(e) provides that section 36-9-607 "does not determine whether an account debtor, bank, or other person obligated on collateral owes a duty to a secured party." S.C. CODE ANN. § 36-9-607(e).

83. *McCullough*, 373 S.C. at 54, 644 S.E.2d at 49.

84. *Id.* at 55, 644 S.E.2d at 50.

85. *Id.*

86. *Id.*

87. *Araujo v. S. Bell Tel. & Tel. Co.*, 291 S.C. 54, 57–58, 351 S.E.2d 908, 910 (Ct. App. 1986).

88. *Id.* at 58, 351 S.E.2d at 910.

89. See *supra* text accompanying notes 20–28 (discussing that lenders obtain security interests in collateral to protect themselves from the debtor's default).

90. See *Jensen v. Anderson County Dep't of Soc. Servs.*, 304 S.C. 195, 199, 403 S.E.2d 615, 617 (1991).

*A. A Security Interest as a Sufficient Property Interest for Recognizing a Secured Creditor's Claim Against a Third Party*

In determining that there was no property interest that could provide a basis for establishing a legal duty between a secured creditor and a third party where the security interest was in contractual rights to payment, the *McCullough* court distinguished between tangible and intangible collateral.<sup>91</sup> South Carolina law has long recognized the right of a secured creditor to maintain an action against a third party for “conversion, injury, or destruction” of the secured creditor’s collateral in tangible personal property.<sup>92</sup> Indeed, according to South Carolina’s own legal encyclopedia, “[p]rovided there has been an impairment of the security, the mortgagee is allowed to maintain an action to recover damages from *anyone* who damages the mortgaged property.”<sup>93</sup> The *McCullough* court concedes this right.<sup>94</sup> If a secured creditor can maintain an independent action against a third party for damage to a security interest in tangible personal property, why not allow a secured creditor to maintain the same action against a third party for damage to a security interest in *intangible* collateral? After all, a secured party is unlikely to be concerned with being able to actually use the collateral but rather is more likely concerned with collecting on the value of the collateral in the event of default. Thus, the court did not have to distinguish between a security interest in tangible property and a security interest in intangible property.

One commentator, discussing the *McCullough* court’s distinction between tangible and intangible collateral, noted the following:

I do not understand the court’s distinction between tortious impairment of tangible and intangible collateral. What’s the difference? If the servicing agency was aware that the secured creditor was relying on the stream of payments and nevertheless acted negligently in handling the mortgage lender’s affairs, why should it matter whether the collateral was tangible or not?<sup>95</sup>

Nonetheless, the South Carolina Supreme Court refused to analogize a secured creditor’s interest in intangible rights to payment with a mortgagee’s security interest in tangible personal property.<sup>96</sup>

Courts in other jurisdictions have found no difference between tangible collateral and intangible collateral in recognizing the cause of action at issue in *McCullough*. For instance, in *Baldwin v. Marina City Props., Inc.*,<sup>97</sup> a California appellate court held that a secured creditor had “an accrued cause of action against

---

91. *McCullough*, 373 S.C. at 52, 644 S.E.2d at 48.

92. See *Wilkes v. S. Ry. Co.*, 85 S.C. 346, 347–48, 67 S.E. 292, 293 (1910) (citing *Wylie v. Ohio River & Charleston R.R.*, 48 S.C. 405, 407, 26 S.E. 676, 676 (1897)).

93. 27 S.C. JURIS. *Mortgages* § 70 (1996) (emphasis added).

94. See *McCullough*, 373 S.C. at 50, 644 S.E.2d at 47 (citing *Wilkes*, 85 S.C. at 347–48, 67 S.E. at 293).

95. Dan Schechter, *Loan Servicing Agency Is Not Liable to Mortgage Lender’s Secured Creditor for Tortious Impairment of Intangible Collateral*, COM. FIN. NEWSL. (Westlaw), May 7, 2007, at 36, available at 2007 COMMFINNL 36.

96. *McCullough*, 373 S.C. at 52, 644 S.E.2d at 48.

97. 145 Cal. Rptr. 406 (Ct. App. 1978).

[a third party] for an alleged impairment of the value of the [secured creditor's] collateral" where the collateral was an interest in a limited partnership.<sup>98</sup> In *RFC Capital Corp. v. EarthLink, Inc.*,<sup>99</sup> an Ohio court concluded that a secured creditor could assert a claim against a third party for impairment of its security interest in an internet service provider's customer base.<sup>100</sup> Furthermore, a New York district court in *Pioneer Commercial Funding Corp. v. United Airlines, Inc.*<sup>101</sup> refused to dismiss a claim brought by a group of creditors against a third party for impairment of the group's security interests in its debtor's accounts receivable.<sup>102</sup> Finally, in *Bank of India v. Weg & Myers, P.C.*,<sup>103</sup> a New York court not only recognized a bank's claim against a law firm for impairment of the bank's security interest in its right to receive insurance proceeds, but the court also granted the bank's motion for summary judgment on the same claim.<sup>104</sup> The above cases question whether any other jurisdiction supports the South Carolina Supreme Court's distinction between tangible collateral and intangible collateral for purposes of recognizing a secured party's right to maintain an action against a third party for impairing the secured party's collateral.

1. *Basis for the McCullough Decision: Universal C.I.T. Credit Corp. v. Trapp*

The *McCullough* court based its distinction between tangible and intangible collateral on its earlier decision in *Universal C.I.T. Credit Corp. v. Trapp*<sup>105</sup> and a similar line of cases.<sup>106</sup> In *Universal*, the mortgagor of an automobile brought an action arising out of an automobile collision against another driver for damages to

---

98. *Id.* at 414. In *Baldwin*, the plaintiffs sold their partnership interests in Marina City Properties, the third party in this case, to the debtor. *Id.* at 409. The debtor executed certain promissory notes payable to the plaintiffs, while the plaintiffs retained a security interest in the partnership interests that were being sold. *Id.* The general partner of Marina City Properties subsequently made a capital call to the limited partners that went unanswered. *Id.* at 410. Thereafter, Marina City Properties contributed funds to the limited partnership, and the Certificate of Limited Partnership was amended to reflect this contribution. *Id.* As a result of this amendment, each partnership interest in Marina City Properties was proportionately reduced in value. *Id.* The plaintiffs claimed that the capital call contributions were unnecessary and the result of "self-dealing." *Id.* The court found that the plaintiffs had an accrued cause of action against the third party, Marina City Properties, for impairing the value of the plaintiffs' collateral by its wrongful acts. *Id.* at 414.

99. No. 03AP-735, 2004 WL 2980402 (Ohio Ct. App. Dec. 23, 2004).

100. *Id.* at \*18 ("[A] secured party may . . . assert a claim for the impairment of a security interest if the facts support it.").

101. 122 B.R. 871 (S.D.N.Y. 1991).

102. *Id.* at 885–87. The *Pioneer* court noted that "[w]hile it is true that many of the cases dealing with impairment of security interests involve real property mortgages, . . . there is no reason why other secured interests cannot be protected in a similar fashion." *Id.* at 886 (citation omitted).

103. 691 N.Y.S.2d 439 (N.Y. App. Div. 1999).

104. *Id.* at 445 (stating that the record "warrants summary judgment to the Bank on the claims that Weg & Myers impaired the Bank's security interest").

105. 232 S.C. 297, 101 S.E.2d 829 (1958).

106. *McCullough v. Goodrich & Pennington Mortg. Fund, Inc.*, 373 S.C. 43, 51–52, 644 S.E.2d 43, 48 (2007) (citing *Mercer v. New Amsterdam Cas. Co.*, 189 S.E. 762, 763 (N.C. 1937); *Fidelity Fin. Servs. v. Blaser*, 889 P.2d 268, 272 (Okla. 1994); *Johnson v. Wright*, 280 S.C. 535, 538–39 313 S.E.2d 343, 346 (Ct. App. 1984); *Int'l Harvester Credit Corp. v. Valdez*, 709 P.2d 1233, 1236 (Wash. Ct. App. 1985).

the mortgaged vehicle.<sup>107</sup> While that action was pending, the mortgagee of the damaged automobile notified the at-fault driver of its security interest in the automobile and requested that the at-fault driver respect that interest by including the mortgagee as a payee on any settlement funds paid on the claim.<sup>108</sup> However, the third party ignored the mortgagee's request and settled directly with the mortgagor.<sup>109</sup> The mortgagee, in turn, brought suit against the at-fault driver and his insurer for "willfully and maliciously" interfering with its right to recover the settlement payments for damage to the collateral.<sup>110</sup> The court affirmed the lower court's judgment and held that the third party was under no legal duty to ensure that the mortgagee received its interest in the settlement funds.<sup>111</sup>

The *McCullough* court apparently viewed the *Universal* court's refusal to recognize the claim brought by the mortgagee against the third party tortfeasor as disapproving of claims against third parties for impairment of intangible rights.<sup>112</sup> However, the court in *Universal* focused more on the mortgagee's other available options to protect its interest than on the intangible nature of the interest. The *Universal* court noted that "the plaintiff . . . could have protected its rights by intervening in the action by its mortgagor against the tortfeasor."<sup>113</sup> Additionally, the *Universal* court noted that "[w]hen the mortgagor has received payment for the damages, . . . [the] mortgagee . . . may enforce [payment] by appropriate proceedings" because the funds are held in trust for the mortgagee.<sup>114</sup> Because the mortgagee in *Universal* could have either intervened in the action brought by his mortgagor or proceeded directly against his mortgagor to recover the portion of the settlement funds held in trust, there were ample means by which the mortgagee could have protected its interest. Because of these alternative remedies, there was no reason for the court to create a legal duty owed by a third party to a secured creditor to ensure protection of the mortgagee's rights. The intangible nature of the mortgagee's rights to payment seems to be of no consequence in the *Universal* court's analysis. Thus, the South Carolina Supreme Court did not have to read *Universal* as prioritizing tangible property rights over intangible property rights.

## 2. *Universal No Longer Applicable*

Notably, *Universal* was decided before the adoption of Article 9 and, more specifically, before South Carolina adopted current section 36-9-102(a)(64)'s expanded definition of *proceeds*. To fully understand the significance of this adoption requires an overview of the history and development of section 36-9-102(a)(64).

---

107. 232 S.C. at 298, 101 S.E.2d at 830.

108. *Id.* at 298–99, 101 S.E.2d at 830.

109. *Id.* at 299, 101 S.E.2d at 830.

110. *Id.* at 298, 101 S.E.2d at 830.

111. *Id.* at 301–03, 101 S.E.2d at 831–33.

112. See *McCullough v. Goodrich & Pennington Mortg. Fund, Inc.*, 373 S.C. 43, 51–52, 644 S.E.2d 43, 48 (2007) (discussing *Universal* and finding, based on the decision in that case, that a security interest in intangible rights does not create the same basis for recognizing a legal duty as a security interest in tangible rights does).

113. 232 S.C. at 300, 101 S.E.2d at 831.

114. *Id.* (quoting *Harris v. Seaboard Air Line Ry. Co.*, 130 S.E. 319, 323 (N.C. 1925)).

In 2001, the South Carolina General Assembly adopted the revised version of Article 9 in sections 36-9-101 to -709 of the South Carolina Code,<sup>115</sup> superseding the former version of Article 9.<sup>116</sup> Section 36-9-315 of the South Carolina Code provides that “a security interest attaches to any identifiable proceeds of collateral.”<sup>117</sup> Section 36-9-102(a)(64) defines *proceeds* to include any “rights arising out of collateral,”<sup>118</sup> as well as any “claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral.”<sup>119</sup> Thus, the plain language of revised Article 9 clearly suggests that *proceeds* encompasses a secured party’s security interest not only in the debtor’s right to settlement funds payable for damage to the collateral but also in the debtor’s tort claim for damage to the collateral.

Revised Article 9 expanded the definition of *proceeds* beyond its definition under former Article 9.<sup>120</sup> The previous version of section 36-9-306, effective in South Carolina in 1989,<sup>121</sup> defined *proceeds* simply as anything “received upon the sale, exchange, collection, or other disposition of collateral or proceeds.”<sup>122</sup> Additionally, the prior definition specifically stated that any “[i]nsurance payable by reason of loss or damage to the collateral” constituted proceeds, and thus, a secured creditor had a security interest in such casualty insurance payments.<sup>123</sup> However, under the previous definition of *proceeds* in section 9-306 of the Uniform Commercial Code (UCC), courts expressed uncertainty as to whether a secured creditor had a security interest in settlement funds or damage awards received by the debtor in a tort action against a third party for damage to the collateral.<sup>124</sup> This uncertainty may seem perplexing because tort settlements and casualty insurance payments are conceptually alike, in that “each arise on account of an event that damages the collateral’s economic value.”<sup>125</sup> In *McGonigle v. Combs*,<sup>126</sup> decided under the prior version of section 9-306, the court held that settlement funds received by the debtor for a securities fraud claim constituted proceeds of the securities, giving the secured creditor a security interest in the settlement funds.<sup>127</sup> Section 36-9-102(a)(64) of the South Carolina Code appears to codify the Ninth

---

115. Uniform Commercial Code, 2001 S.C. Acts 1223 (codified at S.C. CODE ANN. §§ 36-9-101 to -709 (2003 & Supp. 2006)).

116. S.C. CODE ANN. § 36-9-101 cmt. 1 (2003).

117. *Id.* § 36-9-315(a)(2); *see also id.* § 36-9-315 cmt. 3 (“[A] security interest attaches to any identifiable ‘proceeds,’ as defined in Section 9-102.”).

118. *Id.* § 36-9-102(a)(64)(C).

119. *Id.* § 36-9-102(a)(64)(D).

120. *Id.* § 36-9-102 cmt. 13 (“The revised definition of ‘proceeds’ expands the definition beyond that contained in former Section 9-306 and resolves ambiguities in the former Section.”).

121. Uniform Commercial Code, 1989 S.C. Acts 4530 (current version at S.C. CODE ANN. 36-9-101 to -709 (2003 & Supp. 2006)).

122. S.C. CODE ANN. § 36-9-306(1) (Supp. 1989).

123. *Id.*; *see also id.* cmt. 1 (“[This section] makes clear that insurance proceeds from casualty loss of collateral are proceeds within the meaning of [section 36-9-306].”).

124. *Compare* *Sicherman v. Falkenberg* (*In re Falkenberg*), 136 B.R. 481, 485 (Bankr. N.D. Ohio 1992) (stating that settlement proceeds “came within [section] 9-306’s definition of ‘proceeds’”), *with* *Jarboe v. First Nat’l Bank of Pryor* (*In re Boyd*), 658 P.2d 470, 474 (Okla. 1983) (“[M]onies recovered by debtor from a third party as a result of debtor’s claim in tort against the third party are not ‘proceeds’ under [section] 9-306(1) . . .”).

125. Freyermuth, *supra* note 3, at 672.

126. 968 F.2d 810 (9th Cir. 1992).

127. *Id.* at 828.

Circuit's decision in its expanded definition of *proceeds*.<sup>128</sup> Thus, under section 36-9-102(a)(64), a secured party now has a security interest in any settlement funds payable to the debtor as a result of a claim arising from damage to the secured party's collateral.

Prior to the adoption of section 36-9-102(a)(64) and its expansion of the definition of *proceeds*, a mortgagee in South Carolina did not possess a security interest in settlement funds payable to the debtor from a tort claim arising from damage to the collateral. As such, the mortgagee in *Universal*, decided before the adoption of Article 9, only had a security interest in the automobile itself and not in the settlement funds to be paid by the tortfeasor for damaging the automobile.<sup>129</sup> Therefore, the third party could not have impaired any security interest of the mortgagee when it made settlement payments to the mortgagor.<sup>130</sup> If the same facts in *Universal* arose today, however, the mortgagee would have a security interest in the settlement funds payable on the mortgagor's tort claim as such funds now constitute "proceeds" of collateral.<sup>131</sup> Because the mortgagee in *Universal* was asserting that the defendants interfered with its rights in the settlement funds<sup>132</sup> and because today the settlement funds would be subject to a security interest, the following question arises: is a security interest a sufficient property interest to allow the secured party to bring an action, in its own right, against a third party for impairing the property subject to a security interest?

One commentator has aptly answered this question, noting that a secured creditor's bundle of rights associated with its security interest "should be significant enough to constitute the secured lender a real party in interest with standing to bring an action against a person who damages the collateral . . . ."<sup>133</sup> Not the least of these rights is the secured party's right to take actual possession of the collateral upon default by the debtor.<sup>134</sup> However, many of the rights in the bundle can only be determined by referencing the particular security agreement entered into between the parties.<sup>135</sup> The secured party's bundle of rights, whether stated in the security agreement or not, will be worth significantly less in the open market "to a potential assignee of those rights" if the collateral is damaged.<sup>136</sup> Furthermore, if the debtor ultimately defaults, the secured party's rights with respect to the collateral will be worth less to the secured creditor in terms of the value of the collateral upon foreclosure.<sup>137</sup> Because a security arrangement provides a secured party with certain rights regarding the property in which it holds a security interest, those rights should be afforded full protection. As discussed, those rights incident to the security interest are intimately tied to the economic value of the collateral. By recognizing a secured party's right to maintain its own independent claim against a third party

---

128. See S.C. CODE ANN. § 36-9-102(a)(64)(D) (2003) (defining *proceeds* as "claims arising out of . . . damage to . . . the collateral").

129. *Universal C.I.T. Credit Corp. v. Trapp*, 232 S.C. 297, 301, 101 S.E.2d 829, 831–32 (1958).

130. *Id.*

131. See S.C. CODE ANN. § 36-9-102(a)(64).

132. *Universal*, 232 S.C. at 300–01, 101 S.E.2d at 831.

133. Weinberg, *supra* note 4, at 448.

134. *Id.* at 447.

135. *Id.* For instance, the agreement may provide a secured party with the "right to 'police' or otherwise assert dominion over the collateral" prior to default. *Id.*

136. *Id.* at 448.

137. *Id.*

tortfeasor who impairs the economic value of collateral, the bundle of rights associated with the security interest in the collateral remains fully protected. Thus, a security interest in any form of collateral, whether tangible or intangible, should provide a sufficient basis for a secured creditor's right to maintain an independent action against a third party tortfeasor for impairment of collateral.<sup>138</sup> If it had adopted this view, the *McCullough* court could have found that HomeGold's security interest in G&P's contractual rights to receive payment from Advanta provided a sufficient property interest. Such an interest would warrant recognition of the trustee's claim for negligent impairment of collateral.

*B. A Closer Look at Article 9's Expanded Definition of Proceeds*

Section 36-9-102(a)(64) not only adopts the Ninth Circuit's *McGonigle* decision, but it also expands on that decision by treating the tort claim itself, not just the settlement funds or damages recovered, as proceeds of collateral.<sup>139</sup> Under the definition of *proceeds* in former section 9-306 of the UCC, courts had held the term *proceeds* did not include the debtor's right of action against a third party for damage to collateral.<sup>140</sup> For example, in *Bank of New York v. Margiotta*,<sup>141</sup> a New York court addressed "whether '*identifiable proceeds*' may be stretched to include a cause of action."<sup>142</sup> Under the former definition of *proceeds*, the New York court concluded that it could not; therefore, the secured creditor could not maintain an action against a third party for damaging the creditor's collateral.<sup>143</sup> At least one commentator has expressed disagreement, noting that "[a] tort claim for negligent damage to collateral arises on account of an event that damaged the collateral's economic value. As a result, a tort claim falls squarely within the proper scope of the term '*proceeds*' . . . ."<sup>144</sup>

Perhaps, because of this disagreement, the drafters of the revised version of Article 9 sought to address more specifically "the proper scope of the term

---

138. By recognizing a secured party's independent claim against a third party, concerns may arise about holding the third party liable twice for a single wrong, as the debtor presumably has a claim in its own right. However, these concerns could easily be alleviated by allowing the secured party to sue for the entire value of the collateral damaged. *Id.* A constructive trust could then be imposed on any recovery from a judgment or settlement in excess of the debt secured. *See id.* Any judgment or settlement resulting from the secured party's claim would preclude the tortfeasor from incurring further liability on a subsequent claim brought by the debtor. *Id.* Conversely, if the debtor is the first party to bring a suit against the tortfeasor, then any judgment or settlement on that claim would bar the secured party from later bringing a claim. Under this scenario, a constructive trust in favor of the secured party could be imposed equal to the value of the collateral.

This is surely not the only method to prevent courts from imposing double liability on the third party tortfeasor. In applying principles of equity, courts are more than capable of preventing such injustice while simultaneously providing adequate protection to a secured party whose collateral has been impaired.

139. See S.C. CODE ANN. § 36-9-102(a)(64)(D) (2003).

140. See, e.g., *Hoffman v. Snack*, 37 Pa. D. & C.2d 145, 146-47 (Ct. Com. Pl. Allegheny County 1964) ("Absent a sale, exchange or other disposition, there can be no proceeds such as [former Section 9-306] contemplates.").

141. 416 N.Y.S.2d 493 (Dist. Ct. Suffolk County 1979).

142. *Id.* at 495 (emphasis added).

143. *Id.*

144. Freyeremuth, *supra* note 3, at 674.



‘proceeds.’”<sup>145</sup> In doing so, the drafters composed,<sup>146</sup> and the South Carolina legislature ultimately adopted,<sup>147</sup> the language used in the expanded definition of the term *proceeds* in section 36-9-102(a)(64) of the South Carolina Code.<sup>148</sup> The language of subsection (a)(64)(D) provides that proceeds of collateral include any claims that arise from damage or impairment of the secured party’s collateral.<sup>149</sup> In fact, in 2005, a bankruptcy court declared that under the expanded definition of *proceeds*, “[i]t is clear that rights arising from loss or damage to collateral are ‘proceeds . . . .’”<sup>150</sup> Seemingly, a tort claim against a third party for negligently impairing the secured party’s collateral would be included in those rights. Therefore, under subsection (a)(64),<sup>151</sup> in coordination with section 36-9-315(a)(2),<sup>152</sup> a secured party now has a security interest in its debtor’s tort claim against a third party for damaging collateral. Such an interest, in spite of the court’s ruling in *McCullough*, may provide a secured creditor with some form of protection against a third party that impairs the creditor’s collateral.

### C. Options for Protection After *McCullough*

*McCullough*, at first glance, may appear to leave secured creditors whose collateral has been damaged or impaired by a third party without any relief. However, the applicability of the court’s opinion in *McCullough* is limited; the opinion only bars a secured creditor from bringing a claim against a third party that is based on an independent tort duty between the third party and the secured creditor.<sup>153</sup> Secured creditors—under the South Carolina Code—now have a security interest in a debtor’s tort claim against a third party for damaging collateral.<sup>154</sup> Such a security interest may provide relief to a secured creditor when a third party has tortiously impaired the collateral. This relief may be available notwithstanding the *McCullough* court’s refusal to recognize a secured creditor’s independent right to bring a tort claim against a third party.

Section 36-9-607(a)(3) of the South Carolina Code offers some measure of relief to the secured party. This section provides that after default, a secured party may exercise the rights of the debtor with respect to a third party’s obligations on the collateral.<sup>155</sup> The official comment to section 36-9-607 further provides that

145. *Id.* at 692.

146. See U.C.C. § 9-102(a)(64) (2007).

147. Uniform Commercial Code, 2001 S.C. Acts 1248 (codified at S.C. CODE ANN. § 36-9-102(a)(64) (2003)).

148. See S.C. CODE ANN. § 36-9-102(a)(64).

149. *Id.* § 36-9-102(a)(64)(D).

150. *Wiersma v. Kruse (In re Wiersma)*, 324 B.R. 92, 108 (B.A.P. 9th Cir. 2005), *rev’d on other grounds*, 483 F.3d 933, 936 (9th Cir. 2007).

151. S.C. CODE ANN. § 36-9-102(a)(64).

152. *Id.* § 36-9-315(a)(2) (“[A] security interest attaches to any identifiable proceeds of collateral.”).

153. See *McCullough v. Goodrich & Pennington Mortg. Fund, Inc.*, 373 S.C. 43, 55, 644 S.E.2d 43, 50 (2007). (“[W]e answer that South Carolina law does not recognize a secured creditor’s independent claim against a third party for negligent impairment of collateral.”).

154. See *supra* text accompanying notes 115–19, 129–31.

155. S.C. CODE ANN. § 36-9-607(a)(3). Specifically, section 36-9-607(a)(3) provides as follows: [A]fter default, a secured party . . . may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor

“[t]he rights of a secured party under [section 36-9-607(a)] include the right to enforce claims that the debtor may enjoy against others.”<sup>156</sup> Because section 36-9-102(a)(64)(D), in conjunction with section 36-9-315(a)(2), provides a secured party with a security interest in the debtor’s claims against a third party for damaging collateral,<sup>157</sup> section 36-9-607 grants the secured party the right to enforce the debtor’s claim against the third party if the debtor defaults on the loan. Thus, upon the debtor’s default, Article 9 permits subrogation to the secured creditor of the debtor’s accrued claim against a third party for impairing the value of the collateral. The *McCullough* court, in fact, agreed with this point, acknowledging that “th[e] language [of section 36-9-607(a)(3)] appears to permit subrogation of the debtor’s right to the secured party.”<sup>158</sup> Therefore, if the debtor has the right to bring an action against a third party for impairing or damaging the collateral, then upon default, that claim is subrogated to the secured party, allowing the secured creditor to bring the claim against the third party in place of the debtor. Arguably, such a claim did not arise from an independent duty owed by the third party to the secured creditor, as *McCullough* prohibits.<sup>159</sup> Rather, the claim arises from the duty owed by the third party to the debtor.

Applying this reasoning to the facts in *McCullough*, the debtor, G&P, had an accrued cause of action arising from Advanta’s improper servicing of the G&P loans, as Advanta’s conduct impaired Advanta’s ability to make its contractual payments to G&P.<sup>160</sup> Because HomeGold had a security interest in G&P’s rights to receive payment from Advanta, G&P’s claim against Advanta attached as proceeds, thereby giving HomeGold a security interest in G&P’s claim. Under the subrogation theory permitted by section 36-9-607, HomeGold as the secured party would have been able to enforce its debtor’s claim against Advanta, as G&P was delinquent on its loan from HomeGold. Perhaps the fatal flaw in the trustee’s complaint was pleading its claim against Advanta as “negligent” impairment of collateral,<sup>161</sup> implying that the action arose from a legal duty owed by Advanta to HomeGold.<sup>162</sup> But when making a subrogation claim, “[o]rdinarily, one seeking subrogation must plead it and set forth the facts from which the right of subrogation arises.”<sup>163</sup> Thus, section 36-9-607 will often provide a mechanism for protecting

---

with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral.

*Id.*

156. *Id.* cmt. 3.

157. See *supra* text accompanying notes 145–52.

158. *McCullough*, 373 S.C. at 53–54, 644 S.E.2d at 49.

159. See *supra* text accompanying notes 6–12.

160. See *supra* text accompanying notes 41–53. As stated earlier, G&P did in fact bring a claim against Advanta through an arbitration proceeding that was purportedly withdrawn without prejudice. See *supra* note 53.

161. See *supra* text accompanying note 52.

162. Notably, the trustee may have been seeking to avoid the mandatory arbitration provision contained in the agreement between G&P and Advanta by attempting to bring an independent claim. Had the trustee asserted G&P’s rights by bringing a subrogation claim, HomeGold would have been bound by the arbitration provision.

163. *Horton v. Ford Life Ins. Co.*, 518 N.W.2d 88, 92 (Neb. 1994) (citing *Cagle, Inc. v. Sammons*, 254 N.W.2d 398, 403–04 (Neb. 1977)).

secured creditors from impairment of their collateral by third parties by allowing them to make a subrogation claim. However, as noted above, properly pleading the circumstances from which the right to subrogation arises is essential to avoid dismissal of the complaint.

While section 36-9-607 only provides relief to the secured party once the debtor is in default, the secured party may wish to seek relief from its impaired security interest before the debtor becomes delinquent. This can be accomplished by an assignment of the debtor's cause of action against the third party to the secured party.<sup>164</sup> Through an assignment, the secured party (the assignee) would be entitled to "stand in the shoes" of the debtor (assignor) and bring a claim against the third party whose conduct impaired the collateral. As to the terms of the assignment, the debtor and the secured party "should agree as to how any proceeds from such a claim will be applied to extinguish the debtor's obligation to the lender . . . ."<sup>165</sup> However, one potential drawback of an assignment is that the secured party takes the claim subject to any defenses which could have been established against the debtor.<sup>166</sup> Nonetheless, secured parties have a few options with which to protect themselves from third parties that impair the value of their collateral. Thus, the availability of both subrogation and assignment provides the best available protection to those secured parties whose collateral has been impaired.

#### IV. CONCLUSION

For every security interest granted in collateral, a bundle of rights arises that gives a secured creditor a significant interest in that property; these rights should be fully protected, regardless of whether the collateral is tangible or intangible property. The set of rights is intimately connected with the economic value of the property used as collateral. Thus, courts, in protecting a secured party's bundle of rights, should provide a secured creditor with an independent remedy when the economic value of the secured party's collateral has been impaired by a third party's wrongdoing. Unfortunately, the South Carolina Supreme Court in *McCullough* did not agree.<sup>167</sup> However, a secured party may nevertheless be able to protect itself by bringing the debtor's claim against the third party as a subrogation claim once the debtor defaults. Additionally, a secured party may be able to protect itself before the debtor defaults by taking an assignment of the debtor's claim against the third party.

In conclusion, allowing a secured party to maintain an action, in its own right, against the wrongful actions of a third party would provide secured parties with more certain protection from events that impair the value of their collateral. The

---

164. See Amanda K. Esquibel, *An Article 9 Primer Regarding Uninsured Collateral Destroyed by a Tortfeasor*, 46 U. KAN. L. REV. 211, 237–38 (1998). Professor Esquibel's article provides a short discussion of various issues and concerns that may arise for both the secured party and the debtor regarding the assignment of the debtor's claim against a third party. *Id.* at 238–39.

165. *Id.* at 238.

166. See *Chet Adams Co. v. James F. Pedersen Co.*, 308 S.C. 410, 413, 418 S.E.2d 337, 338 (Ct. App. 1992) (citation omitted). Indeed, HomeGold's trustee likely elected not to pursue an assignment of G&P's claim against Advanta because that claim was subject to arbitration. See *supra* note 162.

167. See discussion *supra* Part II.B.2.

less certainty there is in the protection of secured parties' rights, the higher the interest rates will be when secured lenders offer loans to consumers.<sup>168</sup> Because of the uncertainty that has resulted from the decision in *McCullough*, consumers may be faced with higher interest rates. The stated purpose of former Article 9 was to provide a structure in which "secured financing transactions can go forward with less cost and with greater certainty."<sup>169</sup> Following the *McCullough* decision, one cannot help but ponder whether secured transactions will be able to proceed with less cost and greater certainty in South Carolina.

*R. Davis Rice*

---

168. See Esquibel, *supra* note 164, at 220.

169. See S.C. CODE ANN. § 36-9-101 cmt. (Supp. 1989), *superseded by* Uniform Commercial Code, 2001 S.C. Acts 1223 (codified at S.C. CODE ANN. §36-9-101 cmt. 1 (2003)).

\*